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December 15, 2000

Arizona Corporation Commission
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Arizona Corporation Commission
Docket Control-Utilities Division
1200 West Washington
Phoenix, AZ 85007

Re: ACC Docket No. T-01051B-99-0105

Dear Docket Control:

Enclosed for filing are the original and 10 copies of ***AT&T's Post-Hearing Brief*** in the above named docket. A paper copy of both the proprietary and non-proprietary versions of the brief are enclosed. An electronic copy of the brief will be sent via e-mail to the e-mail service list on Monday, December 18, 2000.

Very truly yours,

Davis Wright Tremaine LLP

Larry J. Weathers

Larry J. Weathers
Paralegal

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cc: Rick Wolters
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CERTIFICATE OF SERVICE
ACC Docket No. T-01051B-99-0105

I hereby certify that I have on this 15th day of December 2000 delivered the original and 10 copies of ***AT&T's Post-Hearing Brief*** (Proprietary and Non-Proprietary versions) via FedEx next business morning service to:

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Dated this December 15, 2000

By Larry Weathers

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BEFORE THE ARIZONA CORPORATION COMMISSION

CARL J. KUNASEK
Chairman
JIM IRVIN
Commissioner
WILLIAM A. MUNDELL
Commissioner

IN THE MATTER OF THE APPLICATION OF U S WEST COMMUNICATIONS, INC., A COLORADO CORPORATION, FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY, THE FAIR VALUE OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON AND TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN.	DOCKET NO. T-01051B-99-0105 AT&T'S POST-HEARING BRIEF **NON-PROPRIETARY VERSION**

I. INTRODUCTION

Qwest Corporation and the Staff of the Arizona Corporation Commission are requesting that the Commission radically change the nature of telecommunications regulation and competition in this state by means of a six-page Price Cap Plan. AT&T Communications of the Mountains States, Inc. ("AT&T") agrees that a properly designed alternative form of regulation could make sense for consumers, Qwest, and competition in Arizona. The structure of the Plan proposed here, however, does not meet those goals. Instead, the Plan as proposed would allow Qwest to stifle what little competition is just beginning to develop in Arizona telecommunications markets. The Plan benefits Qwest, while doing little for consumers, and significantly injuring competitors. For these reasons, AT&T requests that the proposed settlement between Qwest and Staff be rejected.

The problems with the Settlement Agreement and Price Cap Plan posed by Staff and Qwest are myriad, ranging from simple typographical errors to structural flaws that pose substantial dangers to consumers and competitors. This brief focuses on the following significant flaws in the Plan and Agreement:

- **The Proposed Revenue Requirement is Too High:** Because the revenue requirement established by the Price Cap Plan is overstated, the approved Qwest prices going into the Plan are too high, to the detriment of Arizona consumers.
- **The Proposed Productivity Factor is Too Low:** The Plan fails to share with consumers gains that Qwest is likely to experience because the productivity factor is set too low and because the productivity calculation fails to consider gains in productivity that are likely to occur during the term of the Plan.
- **Switched Access Rates Remain Substantially Above Cost:** The Plan injures consumers because it fails to reduce Qwest's charges for switched access to a competitive level, ensuring that intraLATA toll rates will remain substantially higher than they would be in a competitive market.
- **New Services and Packages Automatically Receive Pricing Flexibility:** The Plan circumvents existing Commission rules by giving Qwest flexible pricing for any new service and for any service presently classified as non-competitive simply by offering the service in a package with a competitive service. This effectively grants Qwest pricing flexibility for all existing services.
- **Qwest's Ability to Spot Price Undercuts Competition:** In combination with the ability to obtain flexible pricing for any service, the Plan also undercuts competition by permitting Qwest to engage in "spot" pricing. The Plan permits Qwest to offer different packages and different prices in any geographic area chosen by Qwest. This permits Qwest to undercut prices of services offered by competitors in the limited geographic areas where Qwest faces competition while maintaining or increasing its profit margin in other areas.
- **The Plan Does not Adequately Define the Price Floors for Basket 3 Services:** The Plan fails to establish the price floors for services in Basket 3, exacerbating the potential for anti-competitive pricing on the part of Qwest.

- **Insufficient Notice and Opportunity for Commission Review:** The proposed Plan does not allow competitors or the Commission sufficient opportunity to review Qwest's pricing proposals.
- **The Agreement Is Riddled with Errors and Ambiguities:** There are miscellaneous errors and ambiguities in both the Plan and the Settlement Agreement that provide a potential for misunderstanding and litigation that will burden the Commission and the competitive process, all to the ultimate detriment of Arizona consumers.

As requested, attached to this brief is an outline of changes proposed to the Agreement and Price Cap Plan. The remainder of this brief expands upon the most significant problems found in the Plan and Agreement and explains why changes proposed by AT&T are necessary to ensure that alternative regulation in Arizona will ultimately benefit consumers and competition as well as Qwest.

II. ARGUMENT

A. The Revenue Requirement Established by the Settlement Is Overstated.

Prior to the settlement, Qwest and Staff were the only parties to this proceeding who had filed testimony indicating that Qwest was entitled to **any** increase in revenue in Arizona. In contrast, RUCO, AT&T and the Department of Defense separately filed testimony demonstrating that Qwest was substantially over-earning in Arizona and that it should implement revenue reductions in a range between $40 million and $200 million.

The Settlement Agreement and Plan ignore this testimony, allowing Qwest to increase the revenue it derives from Arizona consumers by $42.9 million. Staff's decision to ignore intervenor adjustments entirely and to permit such a substantial increase in Qwest's revenue requirement is arbitrary and will result in rates being charged to Arizona consumers that are neither just nor reasonable, contrary to Arizona law. *See* A.R.S. 40-361.

Commission Staff, AT&T, RUCO, and the Department of Defense, each filed substantial testimony in this proceeding describing the adjustments required to Qwest's proposed rate base and earnings to develop a revenue requirement that would lead to just and reasonable rates. Ms. Susan Gately and Dr. Lee Selwyn, for example, identify several adjustments that differ from those proposed by Staff in this proceeding and point out that many of these adjustments have been required by commissions in other states in reviewing prior Qwest rate proposals. The cumulative effect of reductions proposed by all the parties would be to decrease Qwest's revenue in Arizona by more than $200 million from their current level. *See* Exs. Staff 16, AT&T 6 to 9; RUCO 3, DOD 2 and 3.

In the face of this testimony, the Settlement Agreement's proposal to allow Qwest a $42.9 million rate increase cannot be justified. As Qwest witness Mr. Redding has admitted, the parties to the settlement arrived at the $42.9 million revenue figure by according no value to adjustments proposed by any party other than Staff. Tr. 166. This approach ignores the real possibility that the Commission would accept some or all of these adjustments if this case proceeded through litigation.

As an example, consider the directory imputation adjustment proposed by Dr. Selwyn and Ms. Gately. This adjustment is based on the principle that Qwest's directory business in Arizona is a regulatory asset of Qwest in Arizona and that Qwest should, therefore, be required to impute to its regulated business the fair value of fees and services provided by Qwest in Arizona to the directory affiliate. *See, e.g.*, Ex. AT&T 9 at 29-39. Dr. Selwyn's analysis determined Qwest should be required to impute the full amount of Yellow Pages revenues attributable to Arizona, net of expenses -- $184 million. *See* Ex. AT&T 5 at 33.

Staff witness Mr. Brosch conducted his own analysis of the imputation requirement. He determined that the amount of imputation that should be required was between $93 million and $104 million. Ex. Staff 7 at 48. Yet, notwithstanding this calculation, Staff and Qwest agreed to impute only $43 million in calculating the revenue requirement for purposes of the Settlement Agreement.

The only basis for Staff's decision to agree to such a limited imputation amount is a 1988 settlement agreement between the Commission and Qwest predecessor, Mountain Bell. *See*

Ex. Qwest 48. Both that settlement and case law interpreting the settlement, however, recognize that the amount agreed upon as imputation in 1988 could be adjusted in future rate cases. *Id; see also* Ex. Qwest 49. Moreover, as Mr. Brosch himself admits,

> That $43 million amount is woefully inadequate as imputation of a reasonable ratepayer's share of the directory publishing business.

Id. at 47.

Based on the testimony of Staff witness Mr. Brosch and AT&T witness Dr. Selwyn, the Commission very well could have determined that a directory imputation adjustment significantly larger than $43 million was required to ensure that Arizona consumers were treated fairly and charged just and reasonable rates. This single adjustment, even using Mr. Brosch's calculation on behalf of Staff, would eliminate or virtually eliminate the additional revenue requirement established by the Settlement Agreement. Nevertheless, Staff and Qwest ignored this adjustment in coming to an agreement.

AT&T, RUCO and the Department of Defense have proposed numerous other revenue adjustments that should have been accorded value for the purposes of settling this dispute. Even if only some or a portion of these adjustments were adopted, it is clear that the Settlement Agreement starts from an improperly inflated revenue requirement in determining rates that Qwest may charge to Arizona consumers under the Plan. The rates generated under the Plan, therefore, cannot be just and reasonable.

Moreover, as Dr. Johnson has testified, regulators commonly require regulated telecommunications carriers to accept rate reductions or a sharing of revenue gains in return for the increased pricing flexibility and other benefits of price cap regulation. Ex. RUCO 14 at 9. Here, Qwest has essentially negotiated a revenue increase with no evidence that such an increase is warranted. For these reasons alone, the Commission must reject the settlement between Qwest and Staff.

B. The Agreement Fails to Share Productivity Gains with Consumers.

Compounding the problem caused by the fact that this Settlement Agreement starts with rates that are too high, the Agreement also fails to share with consumers an appropriate amount of the productivity gains likely to be made by Qwest during the term of the Plan. The very purpose of a price cap plan is to allow both the incumbent carrier and consumers to benefit from operating efficiencies achieved by the carrier during the course of the Plan. *See* Ex. AT&T 5 at 5. Here, however, there are a number of significant problems with the proposed productivity or "X-factor" to be used in calculating Qwest's increased efficiency. First, Staff has admitted that the calculation relies on insufficient data. In addition, the factor is significantly below productivity factors accepted by Qwest both at the FCC and in other states. There is also no proposal to adjust for additional productivity gains Qwest may experience during the three-year period of the Plan, such as gains resulting from the merger between U S WEST and Qwest and the sale by Qwest of rural exchanges to Citizens. Finally, the X-factor does not apply across the board to all Qwest services, but rather only to the monopoly services in Basket 1. This results in an actual effective X-factor is substantially below the 4.2% represented in the Settlement Agreement. These significant limitations in the productivity calculation ensure that consumers will not benefit from all of Qwest's anticipated efficiency gains during the term of this Plan.

Staff conducted no independent productivity study in determining an appropriate factor for measuring Qwest's efficiency gains. The productivity data relied upon in calculating the X-factor proposed by the Plan is based completely upon limited evidence provided by Qwest of its past productivity gains. Ex. Staff 12 at 12-13. Mr. Shooshan, whose staff performed the calculation, has admitted that Staff sought additional information from Qwest to ensure the accuracy of its calculation. *Id.* Mr. Shooshan did not receive that information in time for use in calculating the 4.2% X-factor, and he has never reanalyzed the calculation based on the additional information. Ex. 3 at 13-14.

Because Mr. Shooshan had such limited information, he relied upon figures including an adjusted Qwest revenue stream, with no evidence of the basis for the adjustments. Without knowing whether the adjustments where appropriate, Staff should have used an unadjusted Qwest revenue stream to ensure a more accurate measure of Qwest's productivity gains. Ex. AT&T 3 at 13-14. Use of the proper revenue stream results in an X-factor of at least 5.3%. *Id.* at 14.

This higher X-factor is more in line with productivity adjustments accepted in other Qwest jurisdictions. For example, earlier this year, Qwest became a signatory to the CALLS settlement in which it agreed to a 6.5% X-factor for reductions to interstate switched access charges. *Id.* at 12. Qwest has also recently agreed to a 6.2% X-factor for the price formula adopted in Utah. *Id.*, 20-21. Qwest has provided no explanation for why this Commission should agree to a smaller X-factor than those Qwest has voluntarily agreed to accept in other jurisdictions.

One of the reasons that the Commission should require a larger X-factor is the likelihood that Qwest will, in fact, experience greater productivity increases during the term of the Plan than it has historically experienced. Qwest represented to the Commission in the merger proceeding regarding the Qwest/U S WEST merger that the merger would result in efficiency gains. Tr. 79-80. The historical data used in this proceeding, however, did not take these efficiencies into account. Tr. 83. The historical data also did not take in account efficiencies that Qwest may experience due to sales of high-cost exchanges that it expects to complete sometime in 2001. Failure to consider these factors must render the Settlement Agreement's productivity adjustment suspect.

Finally, because the X-factor applies only to services found in Basket 1, the actual effective X-factor is substantially below the 4.2% set forth in the Agreement. Qwest witness Ms. Mason has admitted that if Qwest experiences productivity gains for the retail services in Basket 1, there is no reason to believe that it will not also experience those gains for the wholesale services in Basket 2. Tr. 114. This makes sense, since the same underlying facilitie are used by Qwest to provide both wholesale and retail services. There is no reason for limiting the benefit of Qwest's increased productivity to monopoly retail services, particularly when competitors must make use of wholesale services provided by Qwest in seeking to make competitive inroads to Qwest's monopoly.

The effect of not applying the X-factor in Baskets 2 or 3 is that the overall productivity benefit to Arizona consumers is substantially less than 4.2%. Although the actual X-factor cannot be calculated without knowing precisely what share of Qwest's revenue is represented in each Basket, the following table shows what the effect of X-factor would be making logical assumptions about the revenue share and the possible year-to-year increase in the gross domestic product-price index ("GDP-PI").[1]

Basket	Applicable X-Factor	Revenue Share	Weighted Value
1	- 4.2%	50%	- 2.10%
2	- 2.0%	25%	- 0.50%
3	+ 10.0%	25%	+ 2.50%
EFFECTIVE X-FACTOR			- 0.10%

This example demonstrates that when viewed comprehensively across all of Qwest's intrastate services, the "productivity offset" may all but vanish. This will necessarily result in excessive rate levels. AT&T Ex. 3 at 23.

The proposal attached as Exhibit A includes a 6.5% X-factor applied across Qwest services. These changes to the proposed settlement are necessary to ensure that consumers receive the efficiency benefits that should result from implementation of a price Plan.

C. The Agreement Fails to Set Access Rates at Cost.

In order to reach end use customers who receive their local service from Qwest, providers of toll services have no option but to purchase switched access services from Qwest to originate and terminate toll calls. *See* AT&T Ex. 2 at 5-6. Because Qwest still maintains monopoly power in the local market, Qwest is able to charge substantially more than its cost of providing switched access services. *Id.* at 22-23; *see also* Tr. 186. This injures Arizona consumers by improperly

[1] This table is reproduced from AT&T Ex. 3 at 23.

inflating the cost of toll services. *Id.* at 34-35. As Qwest agrees, switched access must move towards cost to mirror the rates that would result from a competitive market. Tr. 189.

Recognizing these concerns, Staff expert Mr. Shooshan recommended that Qwest's switched access prices be reduced substantially over the course of the Price Cap Plan. *See* Ex. Staff 12 at 12. Mr. Shooshan recommended that access rates be reduced to a level agreed upon by Qwest as part of the CALLS proposal for interstate access charges. *Id.* This would require a reduction of Qwest's access charges from the composite rate of approximately 4.5 cents per minute charged today[2] to the interstate rate of 0.5 cents per minute. *See* Ex. AT&T 1 at 3.

The proposed Settlement Agreement abandons this approach, guaranteeing the toll rates for Arizona consumers will remain higher than they would experience in a competitive market. Under the proposed agreement, access rates are reduced by only $15 million over the 3-year term of the Plan, resulting in a composite rate of 3.3 cents per minute. *Id.* The gap between cost and price of switched access under this proposal remains astronomical. This has a substantial negative impact on consumers and competition in Arizona's telecommunications market. *Id.* at 8

Another problem with the structure of the Agreement is the failure to designate how access reductions will occur in the second and third years of the Plan. There are many different rate elements that combine to make up the cost per minute of access services. Without information regarding how each of those rates will change during the course of the Plan, interexchange carriers cannot determine how they will be affected by the rate reduction scheduled in years 2 and 3. *Id.* at 6.

These problems must be corrected to yield a proposal that will benefit both competition and consumers. The revised plan proposed by AT&T would reduce switched access rates to interstate levels over a five-year transition period, consistent with the transition Qwest has agreed to accept in the CALLS proposal. The rate reductions will come initially by eliminating the

[2] 4.5 cents is the switched access average weighted rate per minute for origination or termination of a telephone call. The cost to an interexchange carrier to both originate and terminate a telephone call on Qwest's network is 9 cents per minute.

interconnection charge. As Qwest admits, these are usage sensitive charges that bear no relationship to any underlying usage-based costs. Tr. 188. Eliminating these charges is necessary to bring switched access charges more in line with a competitive market. Ex. AT&T 1 at 5-6.

D. The Price Cap Plan Circumvents Existing Rules in Place to Prevent Competitive Injury.

The Commission requires that before any telecommunications service may be classified as competitive, the carrier seeking competitive classification must "demonstrate that the telecommunications service is competitive" based upon conditions within the relevant market. *See* A.C.C. R 14-2-1108(B). The telecommunications company supporting a petition for competitive classification has the burden of demonstrating that the service is competitive. To meet this burden, the carrier must provide evidence of general economic conditions within relevant market, the number of alternative providers of the service, and market share of alternative providers, the ability of alternative providers to make functionally equivalent or substitute services readily available at competitive rates, terms and conditions, and other indicators of market power. *Id.* This ensures that competitors and consumers do not suffer the consequences of permitting a carrier to flexibly price services when there is no price constraining competition for those services available in the market.

The proposed agreement writes this rule out of the books. Under the proposed agreement, any new service will automatically be accorded competitive status. For example, today custom calling features are treated as monopoly services because Qwest continues to maintain monopoly power in the provision of local exchange service, and with it a monopoly in the provision of calling features to local exchange customers. Under the proposed settlement, Qwest could introduce a new custom calling feature and have that feature declared competitive, even though the features can only be offered by Qwest as a monopoly provider of local service. Tr. 284. This denies the Commission an opportunity to judge whether the new service actually faces competition before Qwest is permitted to offer that service with flexible pricing throughout Arizona.

The agreement also permits Qwest to offer any Basket 1 monopoly service in Basket 3 with flexible pricing so long as that service is offered in combination with at least one other service in Basket 3.[3] For example, Qwest could combine 1FR or 1FB service with 25 minutes of intraLATA toll, a Basket 3 service, and obtain the ability to flexibly price the "package." Tr. 300. In essence, this allows Qwest to move any Basket 1 service into Basket 3 at will. This extreme flexibility gives Qwest every opportunity to injure competitors and consumers, contrary to the public interest in Arizona.

Mr. Dunkel, on behalf of Staff, has testified extensively that permitting Qwest this kind of flexibility in pricing is contrary to the public interest. As Mr. Dunkel stated:

> My experience in other states has been that companies will slightly modify or combine existing services, and claim that this is a "new" service that is therefore competitively priced. For example, if an LEC (*sic*) combines basic exchange service with a new feature that it is not currently combined with, they would argue that is a new service, and therefore competitively priced. This wording could open a large "loophole" which USWC could use to have virtually any service considered "competitive" simply by creating a slightly modified form of it. . . . To be deemed truly competitive, new services should have to pass the same competitive test that other services must pass. If a "new" service includes a service that is currently not classified as competitive, that "new" service clearly cannot be classified competitive. Likewise, I recommend that in any alternative regulatory structure adopted, the new services be subject to the same treatment of price caps as are existing regulated services, unless USWC provides the information needed to demonstrate that they are truly competitive services under Article 11, R-14-2-1108.

Ex. Staff 9 at 36-37. Mr. Dunkel's position is correct, and there is nothing in the record to warrant a different conclusion with respect to the Plan. The Plan should not result in abrogation of a Commission rule designed to protect competitors and consumers in this state. Giving Qwest

[3] As described in Section H below, the agreement actually appears to allow Qwest to package Basket 1 monopoly services together in new ways without any Basket 3 service to qualify the package for flexible pricing in Basket 3. Qwest and Staff clarified at the hearing that the intent of the agreement was to require packaging with a Basket 3 service. Tr.

the freedom to obtain flexible pricing for monopoly services at will creates a substantial danger to the competitors and consumers meant to be protected by R 14-2-1108.

E. The "Spot" Pricing Provision of the Agreement Compounds Its Anti-Competitive Nature.

The problem created by allowing Qwest to obtain flexible pricing at will for monopoly Basket 1 services is compounded by another provision of the Agreement which gives Qwest even greater pricing flexibility. Paragraph 4(g) of the Price Cap Plan permits Qwest to offer "new services and packages in Basket 3 . . . to selected customer groups based on their purchasing patterns or geographic location, for example." This provision gives Qwest license to undercut competitors in geographic area where Qwest may face competition, while maintaining higher prices in areas where competition does not exist. This pricing freedom gives Qwest an opportunity to quash what little or no competition exists, to the detriment of competitors and consumers alike.

Mr. Dunkel's testimony demonstrates why the Commission should not permit a settlement agreement with a provision permitting Qwest the opportunity to spot price new services and packages. As Mr. Dunkel has explained, when a utility has monopoly power in some areas but faces competition in other areas,

> It is in the utility's self interest to charge lower prices where it faces competition, while charging higher prices where it has monopoly power . . . . Discriminating based upon the level of competition is in the utility's self interest, but it is not in the public interest. The prevention of this type of undue price discrimination is one of the reasons that utilities are regulated, either by traditional regulation or by alternative regulation.

Ex. Staff 9 at 5-6. As Mr. Dunkel has further explained, permitting a regulated monopoly to charge different prices in different areas based upon the level of competition has significant adverse affects:

> (1) It discourages the growth of competition, and (2) it allows the extraction of monopoly profits where the company has monopoly power. Both of these effects are in the company interest, but not in the public interest.

Id. at 6-7.

For this reason, Mr. Dunkel initially recommended in this proceeding that

> whatever regulatory structure is adopted, include a requirement that prices in different geographic areas may not vary by an amount that is greater than the variation that is justified by any variation in the cost of providing service. If the regulatory structure allows pricing flexibility or "revenue neutral" restructuring, any such restructure may not increase the rate differential between geographic areas that is incorporated in the specifically approved ACC rates, without specific Commission approval.

Id. at 10-11.

As Mr. Dunkel has pointed out, Qwest maintains "huge market power" in many areas of Arizona. *Id.* at 19. As Mr. Dunkel has further stated, Qwest has an incentive, therefore, to devise "new services and packages" that can be offered in limited geographical areas to undercut prices offered by competitors. For example, Qwest might offer a package of basic business exchange service, features and toll only in those areas of the state where it faces competition for business customers. As Qwest has admitted, this has the potential to discipline competitors, slowing, if not destroying, the growth of competition in this state. Qwest could, for example, use targeted price cuts:

> in a preemptive manner, to make competitive entry more difficult or impossible. Similarly, prices may be reduced to the point where competing carriers cannot cover their costs, including the cost of winning customers and gaining market share.

See RUCO Ex. 15 at 2. As Mr. Dunkel has explained, this is contrary to the public interest and should not be permitted.

In the face of the contrary position taken by Staff's own expert in this proceeding, Qwest and Staff now argue that the Price Cap Plan guards against anti-competitive pricing by prohibiting Qwest from discriminating in violation of A.R.S. § 40-334. This "protection" is toothless. The statute cited in the Price Cap Plan simply prohibits public service corporations from maintaining "any unreasonable difference as to rates, charges, service, facilities . . . either between localities or between classes of service." It is apparent that Qwest interprets this provision to permit it substantial flexibility in pricing, so long as it complies with the price floors provided by the Plan. Given that the Plan specifically permits Qwest to offer new services or packages "to selected customer groups based on their purchasing patterns or geographic location" the Plan itself clearly anticipates that Qwest will be able to use this provision as a weapon in responding to competition. In fact, Qwest admits that this increased flexibility to respond to competition is one of its reasons for agreeing to the Price Cap Plan. Ex. Qwest 6 at 20.

F. The Agreement Fails to Establish the Price Floors Applicable to "Competitive" Services.

Qwest's ability to injure competition by repackaging monopoly services and undercutting competitors in those limited geographic areas where it faces some competition is further advanced by the Settlement Agreement's failure to define the price floors Qwest must abide by when pricing Basket 3 services. The Agreement itself states only that "the price of the new package or service shall exceed the TSLRIC of the package or service." *See* Price Cap Plan, ¶ 4. Qwest and Staff have stated that Qwest will also be required to meet the Commission's imputation rules. The Agreement does not indicate, however, what Qwest will be required to impute into the price floors of new packages and services. As it became clear at the hearing, Qwest and Staff have strikingly different views as to what imputation will be required.

An example used with Qwest witness Mr. Teitzel shows how Qwest could use the flexible pricing and ambiguous price floor provided by the Agreement to undercut competitors. The example is set out in Worldcom Exhibit 4. Under Qwest's interpretation of the imputation rules in place in Arizona, it could bundle a package of basic business exchange service, custom ringing, and 10 minutes of intraLATA toll service and offer this package in Basket 3. The current price for these three services is approximately $41.65. Under Qwest's interpretation of the price floor requirements of the Price Cap Plan, Qwest could offer the "new package" for $23.48 in select areas of Arizona, while refusing to offer the "new package" in other areas of the state. Tr. 300-308; Ex. Worldcom 4. [4] For example, if Qwest faced competition for business

[4] Qwest calculate this price by imputing the unbundled loop price of $21.98 into the price floor

customers in Phoenix, it could offer the package price there, while requiring business customers to continue purchasing the three services separately in the rest of the state. *Id.* Any company competing with Qwest in Phoenix would then be forced to reduce its charges to meet or beat the Qwest package.

The pricing differential possible for Qwest under this proposal becomes even more stark if we change the package slightly by adding some of the more popular calling features to the plan. Worldcom Exhibit 2 identifies Arizona Basket 1 features along with the rate and TSLRIC for each feature. As an example, call waiting presently has a business rate of $7.50 and a TSLRIC cost of <PROPRIETARY[ ] PROPRIETARY>. Thirty number speed calling has a business rate of $4.50 and a TSLRIC cost of <PROPRIETARY[ ] PROPRIETARY>. Caller ID with name and number has a business rate of $15.45 and a TSLRIC of <PROPRIETARY[ ] PROPRIETARY>. Adding these features into the equation used in the example above would permit Qwest to charge a package rate of $24.03 in areas where it faces competition, while maintaining its margins by charging $69.00 in other areas of Arizona. Competitors, on the other hand, would have no option to maintain monopoly margins in other areas of the state, because competitors will always face competition from Qwest.

Testimony at the hearing made it clear that Staff and Qwest may have different views as to what imputation may be required. It appears that Staff may be of the view that imputation will be required for features and other essential services. This confusion over how price floors will be calculated for Basket 3, however, makes it impossible to determine exactly how the agreement will effect competition in Arizona and impossible, therefore, to determine whether the

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for basic business exchange services. Qwest would then add the TSLRIC of the custom calling feature as the price floor for that service, and impute the terminating access charge and the TSLRIC of originating access to determine the price floor for intraLATA toll services. AT&T believes that Qwest's calculation is contrary to the economic purpose of imputation and the Commission's Rules. Nevertheless, adoption of Qwest's methodology would have a substantially negative effect on competition, as described above.

Agreement is in the public interest. *See* RUCO Ex. 15 at 3-5. This is an ambiguity that can and should have been addressed by the Agreement itself. *Id.*

Qwest and Staff have responded to this argument, contending that the imputation rules and rules and concerns over interpretation of those rules are not changed by the Settlement Agreement. This argument misses the point. As Dr. Johnson, testifying on behalf of RUCO, has explained,

> If the proposed Price Cap Plan were to be accepted by the Commission, this would have the effect of making the correct interpretation and implementation of these [imputation] rules far more important than before. Under the existing system of regulation, these pricing rules perform a "belt and suspender" function, providing some additional protection from anti-competitive pricing. However, the primary protection is provided by the Commission, and this is not dependent upon the correct interpretation of these rules.

Id. at 5.

Today, Qwest has little incentive to test the boundaries of the imputation rules provided by Arizona law. If the agreement is accepted, however, Qwest will have every incentive to price as close to the price floor as possible in areas where it faces competition, so that it can reduce competitors' margins and discourage further competitive development. In evaluating the proposed Settlement Agreement, therefore, the Commission must recognize that the failure of Qwest and Staff to agree on how price floor will be established makes the Agreement ambiguous. This critical ambiguity ensures that the Commission will be called upon repeatedly to determine the extent to which Qwest is required to impute its own prices for retail services into the price floor of new packages and services offered in accordance with the agreement. This ambiguity is detrimental to competition and contrary to the public interest.

G. The Agreement Fails to Allow Sufficient Notice to Competitors and an Opportunity to Challenge Qwest's Pricing of Services and Packages.

Competitors will certainly be affected by any "new package or service" offered by Qwest and, therefore, have a substantial competitive interest in ensuring that the pricing for these new packages or services exceeds a properly computed price floor. This interest is particularly affected by this proposed agreement because of the agreement's failure to define the price floors that will apply to new services and packages. Nevertheless, under the terms agreed between Qwest and Staff, competitors will receive no notice of Qwest's proposals for new services or packages.

Moreover, the Commission is given only 30 days to act on any newly proposed package or service, including the time necessary to determine whether the package or service complies with imputation requirements and the discrimination requirements, such as they are, provided by A.R.S. § 40-334. Under this proposal, unless competitors monitor every Qwest tariff filing, it is likely that they will not recognize attempts by Qwest to engage in anti-competitive pricing until the pricing is already in place.

Given the extent of the review that will be required for new packages and services, and the need for input from those companies affected by Qwest's proposals, both the extent of notice provided and the 30 day review period itself are insufficient. The Commission and interested parties need sufficient time to review the Qwest cost studies and other documents that must be filed to establish the price floor under Commission Rules. As Qwest admits, its cost studies are confidential and cannot be reviewed by a competitor under the terms of the Plan as presented to the Commission. Tr. 272. Qwest's cost studies have been subject to criticism from this and other Commissions and cannot simply be accepted at face value for purposes of establishing the appropriate price floor for new services. Tr. 283. For these reasons, other carriers should receive specific notice of Quest's proposed new service offerings and the time for review should be extended to 60 days to ensure that Qwest follows all existing Commission rules in making the new offering.

H. Ambiguities and Errors in the Plan Make It Clear That the Plan Was Hastily Drafted Without Due Consideration to the Issues That Might Arise.

In addition to the structural problems with the Plan, there are a number of errors and ambiguities that will create future problems in interpreting and administering the Plan. These errors and ambiguities are particularly problematic because the Settlement Agreement itself states that it "resolves all issues that were raised in the Rate Case and is a complete and total settlement between the parties." Agreement at ¶ 11. Qwest and Staff have agreed that "there are no understandings or commitments other than those specifically set forth [in the agreement]." *Id.* For this reason, even clarifications offered during the course of the hearing do not become part of the Agreement and may trigger later litigation or other proceedings to clarify the meaning and scope of the proposed Settlement.

The price floor issue described above is the most significant of the ambiguities that must be clarified before the Commission can determine whether the Agreement is in the public interest. Unless the Commission knows what price Qwest will be permitted to offer for packages it designs to attack competitive entry, the Commission cannot determine the extent of the adverse affect on competition that will be caused by the Agreement. Nevertheless, even if this problem is corrected, there are additional errors that require redress.

First, the Plan should include a definitions section so that all parties will understand the meaning of the terms used within the document. As an example of the problems that could be resolved with this change, the Plan in paragraph 2(b) uses the term "Price Index" to refer to the weighted average price level of all services contained in Basket 1. The same paragraph, however, uses the term "Price Cap Index" without defining the term. It is unclear whether the Price Index and Price Cap Index have the same meaning.

In the same paragraph 2, the Plan indicates that data Qwest is required to provide to allow the Commission to calculate and monitor the Cap as detailed in Section (6) of the Agreement. There are no details of the data required from Qwest in that Section (6). It may be that the section at issue should actually be Section (5). The intent of the parties, however, is unclear from the document.

Paragraph 3 of the Price Plan states in paragraph 3(g) that nothing in the Plan "is intended to change or modify in any way imputation requirements contained in AAC R14-1-1310." During the course of the hearing, Staff and Qwest took the position that this section should be corrected to read R14-2-1310 and should be read to apply to the entirety of the Agreement.

Nevertheless, the section conflicts with the provision in paragraph 4(e) stating that the price of any new service or package "shall exceed the TSLRIC of the package or service." This ambiguity must be corrected.

There is a further ambiguity in paragraph 4(e) of the Plan. That paragraph states that any services in Basket 1 may be the components of any new package that would be offered in Basket 3. Qwest and Staff took the position at the hearing that new packages required that a Basket 3 service be included before the package could be offered in Basket 3. If this is, in fact, the intent of the parties, it should be made clear in the document.

The same paragraph states that "the mere packaging of existing Basket 1 services does not qualify the existing services to be 'new services'." This statement requires further definition. When is a new package "mere repackaging?" Based on the testimony offered by Qwest witnesses, it appears that even the slightest change to a Basket 1 service would qualify that service as a new package to be offered in Basket 3. If this is not the intent of the parties, the document should be clarified, perhaps by adding examples of "mere repackaging" in contrast to "new services."

The price cap that applies in Basket 3 is unclear. The formula for calculating the price index is set forth in Paragraph 4 of the Price Cap Plan. It appears that index allows a 10% increase per year. Mr. Teitzel, in fact, testified that this was the way the Price Cap was to be calculated. Tr. 287-88. Mr. Teitzel later testified under clarifying questioning from Staff counsel that the increase is limited to 10% over the life of the Plan. Tr. 364. This is not clear from the Plan itself, however, and must be clarified before the Plan is put into effect.

It became clear at the hearing that the parties also differ in their interpretation of paragraph 4(g) of the Agreement. Commission Staff appears to be taking the position that the requirements of ARS Section 40-334 will limit Qwest's ability to offer new services and packages to selected geographic locations. The testimony offered by Qwest during the hearing, however, indicates that Qwest believes it may choose any geographic region and price flexibly so long as it meets the price floor requirements of the Agreement. This disagreement must be clarified before the document is permitted to become effective.

I. Additional Proposals to Increase Benefit to Consumers.

In addition to these problems with the Plan, AT&T proposes the adoption of additional changes that would benefit Arizona consumers. First, the plan as originally proposed by Mr. Shooshan would have extended for a five-year term. *See* Ex. Staff 5 at 3. This extended term would benefit Arizona consumers by ensuring that the plan is "long enough for the new incentives to have impact, but short enough to enable the Commission to review the Company's performance under the plan to ascertain that it is actually providing the expected benefits to consumers." *Id.*

The Plan should also incorporate an opportunity for consumers to share explicitly in any excess earnings generated by the Plan. AT&T has proposed on Attachment A that Qwest be permitted to decide whether it will be protected against the risk of under earning in return for sharing the benefits of over earning with consumers.

Finally, AT&T has proposed strengthening of the service quality provisions of the Plan in order to ensure that Qwest does not sacrifice service quality in response to the increased pricing flexibility that the Plan provides.

III. CONCLUSION

The Settlement Agreement as proposed by Qwest and Staff fails to establish just and reasonable rates, and is harmful to competition and consumers in the State of Arizona. For these reasons, the Agreement is not in the public interest and should be rejected.

DATED this 15th day of December, 2000.

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QWEST INTRASTATE SWITCHED ACCESS RATES
ARIZONA

Transition Qwest's current intrastate switched access rates in Arizona to Qwest's interstate rates as of 8/8/2000 over a five year transition period

	QWEST Current Rate	Year 1	Year 2	Year 3	Year 4	Year 5	Qwest's Interstate Rate
CCL - Originating	0.010000	0.010000	-	-	-	-	-
CCL - Terminating	0.024200	0.018773	0.014319	-	-	-	-
Interconnection Charge	0.006212	-	-	-	-	-	-
Local Switching	0.017300	0.017300	0.017300	0.016499	0.009101	0.002250	0.002250
Transport	0.003078	0.003078	0.003078	0.003078	0.003078	0.002530	0.002530
UNIT COST	**0.041772**	**0.034374**	**0.026975**	**0.019577**	**0.012179**	**0.004780**	**0.004780**

Reduction	**-20%**	**-20%**	**-20%**	**-20%**	**-20%**	
	(0.007398)	**(0.007398)**	**(0.007398)**	**(0.007398)**	**(0.007398)**	**(0.036992)**

Year 1 - Eliminate the IC, reduce the terminating CCL
Year 2 - Eliminate the originating CCL, further reduce the terminating CCL
Year 3 - Eliminate the remaining terminating CCL, reducing local switching
Year 4 - Further reduce local switching
Year 5 - Further reduce local switching and transport so that all rates are equivalent to the interstate rates

ANNUAL REDUCTIONS - % reduction from previous year

		Year 1	Year 2	Year 3	Year 4	Year 5	Cummulative
CCL - Originating		0%	-100%				-100%
CCL - Terminating		-22%	-24%	-100%			-100%
Interconnection Charge		-100%					-100%
Local Switching		0%	0%	-5%	-45%	-75%	-87%
Transport		0%	0%	0%	0%	-18%	-18%
UNIT COST		**-18%**	**-22%**	**-27%**	**-38%**	**-61%**	**-89%**

Based on volumes and rates provided by Qwest in response to WDA-22-011 Attachement F
Industry volumes 10/99 to 12/99 annualized

EXHIBIT 1

Services will be classified into three (3) baskets, as follows:

Basket 1: Noncompetitive retail services

Includes core basic residential and business services and all other rate regulated services except for those being furnished to other carriers (which are in Basket 2) and those for which the Commission shall have affirmatively determined satisfy A.A.C. R14-2-1108 (which shall be placed in Basket 3). Services that are incremental to the core service "platform" and that have no independent existence (i.e., they cannot be provided to customers who do not subscribe for the core service[1]) should also be classified in the same category as the core service, i.e., as non-competitive Basket 1 services.

Basket 2: Noncompetitive services furnished to other carriers

These consist of intrastate access services, bundled wholesale services provided for resale, and unbundled network elements (UNEs), as well as other miscellaneous charges, including, *inter alia*, collocation fees and special construction charges applicable to other carriers.

Basket 3: Competitive services

These consist of services that the Commission has affirmatively determined satisfy A.A.C. R14-2-1108 for reclassification as "competitive" services. There shall be no "presumptive" Basket 3 classification for "new" services, except that those "new" services that are constructed *entirely* out of *existing* elements for which the Commission shall have affirmatively determined satisfy A.A.C. R14-2-1108 may also be placed in Basket 3. "New" services that include any Basket 1 service shall be presumptively classified in Basket 1 unless and until the Commission shall have affirmatively determined satisfy the requirements set forth at A.A.C. R14-2-1108 for reclassification as "competitive" services.

The following pricing rules will apply to these three baskets:

Basket 1: Each Basket 1 rate element will be modified annually by applying the

1. Vertical features, such as call waiting and caller ID, are examples of such services.

change in the PCI to the prior year's price. Qwest may file any rate restructuring tariff changes for these services that it wishes, but such changes will be considered by the Corporation Commission in the same manner in which it considers such changes under existing RORR practices.

Basket 2: All else being equal, rates in this basket will also be modified annually by applying the change in the PCI to the prior year's price, subject to the following exceptions:

(a) Access charges will be reduced annually over a five-year period until they reach parity with interstate access charges. AT&T's specific proposal for these reductions is attached as Exhibit 1.

(b) The price for any individual bundled wholesale services for resale cannot exceed the price that would apply pursuant to Sec. 252(d)(3) of the federal *Telecommunications Act of 1996*, i.e., the price for any bundled wholesale service will be the *lesser* of the price resulting from application of the PCI and the price set pursuant to Sec. 252(d)(3).

(c) Prices for UNEs will be set pursuant to Sec. 252(d)(1), but will be subject to annual price cap rate changes through application of the change in the PCI. As with wholesale services, the price for any UNE will be the *lesser* of the price resulting from application of the PCI and the price set pursuant to Sec. 252(d)(1) and applicable FCC and ACC rules pertaining to the pricing of UNEs.

Basket 3: Services placed in Basket 3 will be afforded full pricing flexibility, subject only to a price floor as describe in this paragraph. However, no service shall be placed in Basket 3 unless and until the Commission shall have affirmatively determined satisfy the requirements set forth at A.A.C. R14-2-1108 for reclassification as "competitive" services. All Basket 3 services shall fully satisfy an imputation requirement with respect to any Basket 1 or Basket 2 service that is incorporated into the Basket 3 service. Specifically, and in order to prevent Qwest from engaging in a price squeeze, the *price floor* for any Basket 3 service shall be the price for all Basket 2 elements *that would be required by a CLEC* to offer a comparable service *plus* the incremental costs to Qwest for the competitive Basket 3 service itself. This requirement shall apply whether Qwest, in providing the Basket 3 service, utilizes the specific Basket 2 element(s) or adopts an alternative serving arrangement that is not available to CLECs.

6. Sharing and low-end earnings protection

Qwest shall be afforded the opportunity, at the outset of the price cap plan, to elect one of the following two alternatives:

(a) No sharing/no low-end protection. If Qwest elects this option, it shall not be required to share any excess earnings with ratepayers for the duration of the price cap plan, but shall also be afforded no "low-end" protection against earnings erosion, even if earnings fall below the level that would be permitted under rate-of-return regulation.

(b) Sharing/low-end protection. Alternatively, Qwest can elect to share earnings with ratepayers on a 50/50 basis for all earnings in excess of 100 basis points above an "authorized rate of return" that shall be determined in a manner similar to the practice under RORR. If earnings fall below 100 basis points under the "authorized" rate of return, Qwest will also be permitted to seek an upward adjustment in rates sufficient to allow it to earn the authorized rate of return. If Option (b) is elected, Qwest shall be required to maintain for the full term of the price cap plan its depreciation rates at the levels in effect as of the outset of the price cap plan.

7. Service quality

Qwest shall be required to maintain service quality levels at a minimum to the those prevailing for the year immediately preceding the adoption of this plan, and shall be required to report relevant service quality data monthly in a form sufficient to demonstrate compliance with this provision. The Commission may, upon determining that service quality shall have deteriorated under price cap regulation, impose financial penalties or, in the event of a sustain deterioration that remains uncorrected over a twelve-month period, terminate the price cap plan and reinstate rate-of-return regulation.

8. Term and review proceeding

This price cap plan shall remain in effect for five (5) years following the effective date of its adoption. At the end of the *fourth* year of the plan, the Commission shall initiate on its own motion a review proceeding that will consider at least all of the following specific issues:

(a) Determination as to whether Arizona consumers have benefited from price cap regulation vs. rate of return regulation.

(b) Determination of an RORR-type revenue requirement for purposes of reinitialization of rates for any continuation of price caps or reversion to RORR.

(c) Determination of an appropriate productivity offset (X) factor based upon productivity experience for not less than eight (8) years preceding the review proceeding.

(d) Determination of such other modifications to the initial price cap plan as the Commission may deem appropriate or, alternatively, determination that Arizona consumers would be better off under RORR, in which event the price cap plan would be terminated at the conclusion of the fifth year and ROR regulation would be reinstated.